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No. 93-1993

In The

Supreme Court of the United States

October Term, 1994

In re WELLS FARGO SECURITIES LITIGATION
WELLS FARGO & CO., et al.,

Petitioners,

vs.

HOWARD GREENWALD, et al.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Did the Ninth Circuit correctly hold that the misrepresentation element of a Rule 10b-5 cause of action was satisfied by a complaint alleging:

> a. that a bank issued financial reports which overstated earnings and assets by failing to provide adequate loss reserves for delinquent and non-performing loans;
>
> b. examples of non-performing loans which the bank failed to recognize and reserve for;
>
> c. various affirmative misstatements in public and government filings regarding the quality of the bank's loan portfolio, the adequacy of its lending procedures and credit monitoring practices, and the sufficiency of existing loan loss reserves;
>
> d. false statements in the public press denying reports that loan losses would increase in the second quarter of 1991, which were made two weeks before the announcement of unprecedented second quarter loan losses and drastic increases in loan loss reserves; and
>
> e. false statements to investors denying knowledge of any reason to explain a significant decline in the price of the bank's stock, made one day before announcement of the drastic increases in losses and loss reserves?

2. Did the Ninth Circuit correctly hold that the scienter element of a Rule 10b-5 cause of action was satisfied by a complaint alleging (d) and (e) above and, in addition:

QUESTIONS PRESENTED – Continued

a. that the bank's management was motivated to inflate earnings and assets in order to maintain their positions and maximize their executive compensation which included incentive bonuses and stock options whose value was tied to stock price; and

b. that by overstating earnings to maintain or inflate the stock price, bank management was attempting to discourage "short selling" by "squeezing" an unusually large number of short sellers who anticipated the price of the bank's stock would decline?

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RESPONDENTS' BRIEF IN OPPOSITION

I. STATEMENT OF THE CASE[1]

In the decision below, a panel of the Ninth Circuit Court of Appeals reviewed plaintiffs' complaint alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)), and S.E.C. Rule 10b-5, and found the detailed allegations adequate for pleading purposes. The 59-page complaint names as defendants Wells

[1] Respondents accept petitioners' statement of jurisdiction and the statutes/rules at issue.

Fargo & Co., a bank holding company, and various individual officers and directors (collectively "Wells Fargo" or "petitioners").

Contrary to petitioners' assertion, this case does *not* arise out of a fall in the price of Wells Fargo & Co. common stock in June 1991. *See* Petn. at 1. The fall in stock price was merely the public market's manifestation of surprise at Wells Fargo's June 25 announcement that it would recognize $180 million in actual loan losses for the second quarter of 1991 ($67 million had been recognized in the first quarter) and that it would add $350 million to its loan loss reserve (four times the $85 million addition in the first quarter). (a-56.) The market's surprise is hardly surprising. Two weeks earlier, Wells Fargo publicly denied reports that it faced an increase in non-performing real estate loans. (a-55.) *One day* before the announcement, when the price of Wells Fargo stock fell (due presumably to leakage of information about the loan losses), the bank continued its pattern of public deception by disclaiming any knowledge of why the stock price had declined. (a-55.)

What this case arises out of is Wells Fargo's conduct in deceiving the investing public in early 1991. Wells Fargo published inaccurate financial statements which inflated earnings and assets by understating the amount of loss reserves required in light of information known to the bank concerning delinquent and non-performing loans. To further this deception, Wells Fargo made a series of affirmative misstatements concerning the quality of the bank's loan portfolio, the adequacy of its lending and credit monitoring procedures, and the sufficiency of its loan loss reserves. (a-51 – a-55.) As noted, it then

publicly denied reports of increasing loan losses at a point in time when management had to know that losses and reserves would drastically increase at the end of the second quarter. Finally, when confronted with the reality of a dramatic decline in the price of its stock, Wells Fargo first denied knowing of any reason to explain the decline and then, one day later, announced the losses and increased reserves.

The complaint specifies examples of problem loans which Wells Fargo knew were in jeopardy but which the bank failed to adequately reserve for. (a-47.) It asserts that Wells Fargo management was motivated to misrepresent the company to the investing public in order to make Wells Fargo appear to be more profitable than it was and thereby increase the value of executive compensation. (a-35 – a-36, a-38, a-47.) The complaint also alleges that by maintaining or inflating its stock price, Wells Fargo sought to discourage "short selling" in the company's stock. (a-60.)

II. SUMMARY OF ARGUMENT

In sustaining the sufficiency of the complaint, the Ninth Circuit opinion does not disagree with nor even question a single decision of another Circuit. Indeed, Wells Fargo does not appear to dispute the settled authority from the Ninth and other Circuits cited in the panel opinion for the proposition that the intentional reporting of inadequate loss reserves can state a cause of action for securities fraud. The panel opinion assumes arguendo the correctness of Wells Fargo's position that plaintiffs must allege "something more" than the mere inadequacy of the

loan loss reserves based on subsequent drastic increases to that account. It also assumes, consistent with Wells Fargo's argument, that plaintiffs must plead facts from which an inference of scienter may be drawn. Applying these legal standards, it nonetheless finds the allegations of the complaint adequate.

Wells Fargo does not dispute the correctness of the legal standards articulated by the Ninth Circuit. Rather it finds fault with the manner in which they were applied to the particular facts of this case. In attempting to disguise the true nature of its argument, Wells Fargo magnifies nonexistent or minimal conflicts among the Circuits and minimizes the fact that the issues on which it seeks review are currently pending before the Ninth Circuit *en banc* in another case.[2] Thus, even if this case could be read to create some slight conflict in tone with the law of another Circuit, that purported conflict may be resolved by a Ninth Circuit *en banc* decision in the very near future. Considering all the circumstances, it is difficult to conceive of a situation less deserving of the attention of this Court at this time.

III. REASONS FOR DENYING PETITION

Wells Fargo has asked this Court to review this case, asserting there is a drastic need for guidance in deciding the degree of particularity required in pleading a Rule 10b-5 cause of action involving the inadequacy of a bank's loan loss reserves and related misstatements.

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[2] Significantly, no judge requested a vote on Wells Fargo's suggestion for rehearing *en banc* in this case. (a-24.)

Although petitioners cite both Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure, the substantive focus of Wells Fargo's argument is on Rule 9(b)'s particularity requirement. Virtually every case Wells Fargo cites as being contrary to the opinion below is a Rule 9(b) decision. *See, e.g., Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96, 99-100 (3d Cir. 1983); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990); *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172-73 (2d Cir. 1990); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067-68 (5th Cir. 1994); *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277-79 (D.C. Cir. 1994).

At the same time, Wells Fargo notes in its petition to this Court that the District Court did not base its dismissal of the complaint on Rule 9(b), and it faults the Ninth Circuit for ignoring the rule in its analysis. Petn. at 3, 9. Indeed, Wells Fargo has filed a renewed motion to dismiss in the District Court, arguing that the Ninth Circuit opinion "leav[es] the Rule 9(b) issue open on remand."[3]

Wells Fargo cannot have it all ways. If its position in the District Court is correct, Wells Fargo is asking this Court to address an issue which the District Court and

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[3] *See* Memorandum In Support of Motion to Dismiss Amended Complaint at 12 n.4, *In re Wells Fargo Securities Litigation*, Master File No. C-91-1944-VRW (N.D. Cal. May 20, 1994). Because this motion was filed after the issuance of mandate from the Ninth Circuit, it is not part of the record in this case but is subject to judicial notice. *See* Fed. R. Evid. 201(b); 21 Charles A. Wright & Kenneth W. Graham, Jr., *Federal Practice and Procedure* § 5106, at 505 (1977).

the Ninth Circuit have not yet decided. If its District Court position is incorrect, there are several additional and independent reasons why the case does not merit this Court's attention.

A. The Ninth Circuit Opinion Articulates No Rule of Law Inconsistent With the Rules Applied In Other Circuits

As framed by the Ninth Circuit opinion, the central legal issues in this case concern the requirements for pleading a 10b-5 cause of action based on the inadequacy of a bank's loan loss reserves and related allegations. Citing precedent from within and outside the Ninth Circuit (*Blackie v. Barrack*, 524 F.2d 891, 904 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 281 (3d Cir.), *cert. denied*, ___ U.S. ___, 113 S. Ct. 365 (1992)), the panel held that defendants could be subject to a claim of securities fraud where they reported financial statements which inflated income and assets by fraudulently underreserving for non-performing loans. Wells Fargo does not dispute this rather unremarkable legal principle. It has focused instead on its contention that "an increase in the loan loss reserve, without more, does not warrant an inference of fraud." (a-6.) Again, however, there is no dispute as to the applicable legal principle. The Ninth Circuit concluded that in addition to the magnitude of the increase in reserves (from $85 million to $350 million between the first and second quarter of 1991), the complaint alleges "something more" in its specification of nine examples of problem loans to corporate borrowers which Wells Fargo knew were in jeopardy. (a-6.) The complaint asserts that Wells Fargo failed to disclose the difficulties with these loans

and failed to take adequate reserves against the losses from these loans it could reasonably anticipate.

Such examples are precisely the type of particularity which two of the cases trumpeted by Wells Fargo suggest should be included in this type of complaint. *See DiLeo v. Ernst & Young*, 901 F.2d at 626-27; *Denny v. Barber*, 576 F.2d 465, 469 (2d Cir. 1978); *see also Serabian v. Amoskeag Bank Shares, Inc.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶98,228, at 99,560 (1st Cir. 1994) (citing *Wells Fargo* with approval). The court below also noted that a mere *two weeks* prior to announcing the drastic increase in reserves, Wells Fargo affirmatively denied that non-performing real estate loans would increase in the second quarter. (a-12, a-55.) To compound matters, one day before announcing the drastic increase in loan losses and reserves, Wells Fargo continued its pattern of deception by denying that it was aware of any reason for a sharp decline in the price of Wells Fargo stock. (a-55.)

Wells Fargo seeks to turn a pleading requirement into a summary judgment procedure before any discovery has taken place. Another of the cases relied on by Wells Fargo warns against precisely this approach: "In applying the first sentence of Rule 9(b) courts must be sensitive to the fact that its application, prior to discovery, may permit sophisticated defrauders to successfully conceal the details of their fraud." *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d at 99-100.[4] Following this admonition, here the Ninth Circuit appropriately rejected Wells

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[4] Wells Fargo not only ignores this cautionary language in *Christidis*, but also fails to acknowledge that in a later case (*Shapiro v. UJB Financial Corp.*, 964 F.2d 272), the Third Circuit applied *Christidis* and reached conclusions completely consistent with the Ninth Circuit's decision in this case.

Fargo's attempt to require the pleading of overly detailed evidentiary facts. "[T]his level of specificity," concluded the court, "is not required at the pleading stage." (a-6.)

As the Ninth Circuit recognized, plaintiffs' complaint is not limited to allegations of fraudulent financial statements. (a-9.) Plaintiffs allege a series of affirmative misstatements regarding the nature of the bank's monitoring and oversight procedures, the quality of the loan portfolio and the adequacy of the loan loss reserves. Wells Fargo takes issue with certain of these allegations which focus on management's opinions or beliefs, contending that the Ninth Circuit misapplied this Court's decision in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749 (1991). In doing so, Wells Fargo again does not argue that the Ninth Circuit applied the incorrect legal standard,[5] but merely repackages its argument that the allegations of the complaint are insufficiently particularized to show that management *knew* its statements of belief and opinion were false. Petn. at 13-14. The argument is no more persuasive in a different wrapping.

Nor can the Ninth Circuit's opinion be read to conflict with the two cases cited by Wells Fargo. All three cases apply the same legal standard: Statements of belief

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[5] Consistent with *Virginia Bankshares*, the Ninth Circuit held that management statements of opinion or belief could be "actionable under § 10(b) [and Rule 10b-5] if 'one of three implied factual assertions is inaccurate: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement.' " (a-12, quoting *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 501 (9th Cir. 1992).)

and opinion are actionable if management did not actually believe the statements or if it lacked a reasonable basis for its belief. (a-12); *In re Time Warner Securities Litigation*, 9 F.3d 259, 266 (2d Cir. 1993); *Kowal v. MCI Communications Corp.*, 16 F.3d at 1277. *Time Warner* merely cites *Virginia Bankshares* as part of a conclusory assertion that the complaint in that case did not support an inference that management lacked good faith or a reasonable basis for its belief. The more detailed discussion in *Kowal* cites *Roots Partnership v. Land's End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992), as an example of an inadequate reserve case which was properly dismissed because the complaint " 'nowhere alleg[ed] what the company's reserves actually were, or what they should have been.' " Here, of course, the complaint alleges that the first quarter reserves of $85 million were understated by at least $350 million (a-59) and that Wells Fargo's loan portfolio included more than $400 million of non-performing loans which were not timely accounted for (a-61).

Finally, Wells Fargo asserts that the Ninth Circuit's decision is inconsistent with decisions from other circuits regarding the degree of particularity necessary to plead scienter in a Rule 10b-5 case. The bank argues a plaintiff cannot merely allege that defendants acted knowingly or recklessly, but must plead facts which give rise to an inference of scienter. It then asserts that the complaint in this case lacks sufficient facts to support such an inference.

Again, Wells Fargo has failed to identify any issue of law which would warrant the attention of this Court even before this case is resolved in the District Court. Despite

the strong argument which can be made to the contrary,[6] the Ninth Circuit assumed *arguendo* the correctness of petitioners' position on scienter and went on to hold that plaintiffs' complaint did allege facts from which scienter could be inferred. Among the facts mentioned by the court were "motive" allegations that management was induced to overstate assets and income because accurate reporting of loan losses and accurate calculation of reserves would have adversely affected executive compensation. (a-14.)

The cases cited by Wells Fargo as being inconsistent with the Ninth Circuit's decision apply the same legal standard and, as a general proposition, turn on their own particular facts. Although *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061 suggests that incentive compensation for management standing alone may be insufficient to raise an inference of scienter (*id.* at 1068-69), the court also recognized that "[t]he particularity demanded by Rule 9(b) necessarily differs with the facts of each case." *Id.* at 1067-68. Those facts here include the additional allegations that Wells Fargo was attempting to squeeze short sellers. More importantly, as the court explained in another of the cases relied on by

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[6] Rule 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting the fraud or mistake shall be stated with particularity. Malice, intent, knowledge and other condition of mind of a person *may be averred generally.*" (Emphasis added.) The second sentence of the Rule clearly qualifies the first and means that a defendant's scienter may be alleged without pleading evidentiary facts from which mental state can be inferred. *See, e.g., McGinty v. Beranger Volkswagen, Inc.*, 633 F.2d 226, 228 (1st Cir. 1980).

Wells Fargo (*Greenstone v. Cambex Corp.*, 975 F.2d 22 (1st Cir. 1992)), the nature and timing of a disclosure may readily permit the inference that company officials knew the underlying facts at an earlier time.[7] *Id.* at 26. Here it strains credulity to think that just two weeks before announcing a *four-fold increase* in loan loss reserves due in significant part to non-performing real estate loans, Wells Fargo could in good faith publicly deny reports that real estate loan losses would increase in the second quarter. And it is well-nigh impossible that Wells Fargo "knew of no reason to explain" the decline in its stock price *one day* before it announced a catastrophic increase in losses and reserves. Clearly, this final denial was merely the last public act in a course of deceptive conduct which, within hours, Wells Fargo management concluded had to come to an end.[8]

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[7] As was the case with the Third Circuit (*see* n.4, *supra*), the First Circuit has decided a case more recently than the case relied on by Wells Fargo and reached conclusions consistent with the Ninth Circuit's decision in this case. *See Serabian v. Amoskeag Bank Shares, Inc.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶98,228.

[8] Although not cited in the petition due to its recency, Wells Fargo may rely on *Shields v. Citytrust Bancorp, Inc.*, No. 93-7738, 1994 U.S. App. LEXIS 13465 (2d Cir. June 2, 1994), which distinguishes *Wells Fargo* because it "did not discuss the pleading requirements of Rule 9(b)," but observes that "the opinion in *GlenFed* [*In re GlenFed, Inc. Securities Litigation*, 11 F.3d 843 (9th Cir. 1993)] and the dissent by Judge Trott in *Wells Fargo* are more consonant with case law in this Circuit." 1994 U.S. App. LEXIS 13465, at *26.

As we later emphasize (pp. 13-14, *infra*), because the Ninth Circuit is currently considering *GlenFed en banc*, the Circuit position on the issues raised by Wells Fargo is as yet unsettled.

In short, the decision below applies the legal standards urged by Wells Fargo, albeit reaching a conclusion with which it disagrees. In effect, everyone accepts the definition of the strike zone and we are merely disputing whether a particular pitch was over the plate. Just as an umpire will not suffer a manager arguing balls and strikes, it is not this Court's function to hear arguments over the adequacy of a particular pleading where no significant issue of law is presented.

To say there is disagreement between the Second and Ninth Circuits is at best premature. More significantly, this case creates no conflict as to the applicable legal standard. *Shields* cites the *GlenFed* panel opinion as stating the correct rule: "[W]hether the facts in the amended complaint would give rise to an inference that the Defendants either did not believe the statements or knew that the statements were false." 11 F.3d at 849; see *Shields*, 1994 U.S. App. LEXIS 13465, at *25-26. Here, the Ninth Circuit held that the complaint "allege[s] facts which provide a basis for the inference of scienter." (a-14.) The fact that the Second Circuit might have applied the same legal standard to reach a different result is no basis for a grant of certiorari.

Consistent with this analysis, each case necessarily turns on its particular set of pleaded facts. Here, for instance, although *Shields* states that allegations regarding executive compensation alone are insufficient to establish motive (1994 U.S. App. LEXIS 13465, at *19), it does not consider such allegations in combination with assertions that management was attempting to squeeze short sellers. Perhaps most importantly, *Shields* certainly *does not hold* that public denials two weeks and one day before announcing a four-fold increase in loan loss reserves cannot give rise to an inference of scienter.

B. To the Extent Any Minor Conflict Can Be Discerned As To Application of the Standard in Rule 9(b) Cases Involving the Adequacy of a Bank's Loan Loss Reserves, Those Issues Are Currently Before the Ninth Circuit *En Banc* In the *GlenFed* Case

In cataloguing the supposed conflicts created by the Ninth Circuit decision in this case, Wells Fargo mentions in a footnote that the panel opinion is even inconsistent with precedent within the Circuit, citing *In re GlenFed, Inc. Securities Litigation*, 11 F.3d 843. Without acknowledging the obvious implications, Wells Fargo then notes that *GlenFed* "is currently being reviewed by the Ninth Circuit *en banc*." Petn. at 8 n.7.

The pendency of *GlenFed en banc* eviscerates any reason for this Court's intervention in this case. In *GlenFed*, the Ninth Circuit panel squarely addressed the applicability of Rule 9(b) to a complaint alleging the inadequacy of a financial service company's loan loss reserves and related misstatements about asset quality and credit review procedures.[9] The case was argued before the *en banc* panel on April 21, 1994.

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[9] Petitioners have taken the position in the District Court that the opinion in *GlenFed* will likely control the decision in this case:

> In both *GlenFed* and this case, plaintiffs claim that a bank and its officers and directors delayed recognition of losses when they knew or should have known that loan loss reserves were inadequate; that the composition of the loan portfolio and the nature of lending and monitoring practices exposed the institution to imminent risk of loss; that the stock price was artificially inflated; and that defendants deliberately

One of the principal purposes of the *en banc* procedure in the circuit courts is to correct panel decisions which create inter-circuit conflict. *See* Daniel John Meador & Jordana Simone Bernstein, *Appellate Courts in the United States* 38 (1994). We have explained why we disagree with petitioners that any conflict has been created, but the *en banc* hearing may moot this debate. To the extent they are inconsistent, the *en banc* decision in *GlenFed* will clearly supersede this case as an expression of Ninth Circuit law. Rather than concluding prematurely that there is a conflict among the circuits on an issue which may be raised by this case, it would seem far preferable to wait until the Ninth Circuit's position is clarified in *GlenFed*.

IV. CONCLUSION

At the pleading stage, the Ninth Circuit concluded that plaintiffs' complaint was adequate because it states sufficient facts to enable Wells Fargo to prepare a defense. *See Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 540 (9th Cir. 1989). Wells Fargo asks this Court's intercession but can identify no serious question of law presented by the case. Instead, it merely complains that the legal standard it has argued for was applied to reach a conclusion with which it disagrees.

Even if Wells Fargo's petition presented a significant legal issue, review by this Court is simply unnecessary in

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misled the public for the purpose of artificially inflating the stock price.

Memorandum In Support of Motion to Dismiss Amended Complaint, *supra* n.3, at 12.

light of the *GlenFed* case pending *en banc* in the Ninth Circuit. There can be no functional conflict between the Ninth and other Circuits because the position of the Ninth Circuit on the issues raised by Wells Fargo is simply not settled.

In short, there is no need, no reason and no basis for this Court's intervention. We respectfully urge that the petition be denied.

DATED: July 15, 1994

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